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INFO RHEFDIA/DIA WASHINGTON DC  
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RUZDHTR/HOTR WASHINGTON DC//USDAO ISLAMABAD PK//  
RUWSMXI/AMC INTEL CEN SCOTT AFB IL//INO/J2-J//  
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RHMFISS/CDR USCENTCOM MACDILL AFB FL//CCJ2-JCH/HSE//  
RHLFABN/CDR USESUCOM ABNCP VAIHINGEN GE//ECJ2/ECJ3/ECJ5-A//  
RHMFISS/CDR USSOCOM MACDILL AFB FL//SOJ2/HSE//  
RHMFIUU/CDR USTRANSCOM TCJ2 SCOTT AFB IL  
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RUEAIIA/CIA WASHINGTON DC//DDI/OEA//  
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RHEFDIA/DIA WASHINGTON DC//DHO-3//  
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RUETIAA/DIRNSA FT GEORGE G MEADE MD//M112/S2132HT//  
RHCKJAC/JAC MOLESWORTH JCDX RAF MOLESWORTH UK  
RUEKJCS/JOINT STAFF WASHINGTON DC//J2/J5-EUR//  
RUZFNAI/NASIC WRIGHT PATTERSON AFB OH  
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RUZFNAI/NASIC WRIGHT PATTERSON AFB OH//DXOA/TAAO//  
RHEFNGB/NGIC INTEL OPS CHARLOTTESVILLE VA  
RHEFNGB/NGIC INTEL OPS CHARLOTTESVILLE VA//IANG-CE-CM/IANG-GS-AA//  
RHEFNGB/NGIC INTEL OPS CHARLOTTESVILLE VA//IANG/CE/CECM//  
RUCXONI/ONI WASHINGTON DC//32/211//  
RUEALGX/SAF WASHINGTON DC  
RUEKJCS/SECDEF WASHINGTON DC//USDP-ISA-ADMIN//  
RULWAAM/STRATCOM IDHS-90 OFFUTT AFB NE//J22123//  
RUEPGAA/US SURVEY DIV SHAPE BE  
RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL  
RUEHIL/USDAO ISLAMABAD PK  
RUCQSAB/USSOCOM INTEL MACDILL AFB FL  
RUEHLO/AMEMBASSY LONDON 1500  
RUEHNE/AMEMBASSY NEW DELHI 5582  
RUEHBUL/AMEMBASSY KABUL 0989  
RUEHLH/AMCONSUL LAHORE 7965  
RUEHKP/AMCONSUL KARACHI 2363  
RUEHPW/AMCONSUL PESHAWAR 7001  
RUEHRC/DEPT OF AGRICULTURE WASHDC  
RUEATRS/DEPT OF TREASURY WASHDC  
RUCPDOG/DEPT OF COMMERCE WASHDC  
RHEBAAA/DEPT OF ENERGY WASHDC

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SUBJ: BI-WEEKLY REPORT ON ECONOMIC ISSUES, 23 SEPTEMBER 2009

TOP STORIES

1. (SBU) Consumer Price Index (CPI) drops to 10.7 percent in August. The Business Recorder reported that inflation was lower for August. It had declined steadily from October 2008's peak of 25 percent, to 11.2 percent in July. However, analysts are still cautious as domestic oil prices could again rise. (Comment: Analysts also point out that core inflation (the CPI basket of goods and services excluding food and energy), though receding, is still high. The State Bank of Pakistan (SBP) remains hesitant to cut interest rates.)

2. (SBU) On September 11, Dawn and other papers reported that overseas remittances totaled \$780.5 million in August, a 31.8 percent increase over the same period last year. The SBP also reported that monthly remittances are on pace to top FY09's (July

1-June 30) total of \$9 billion (FY08 was \$7.8 billion). The largest inflows in August came from the UAE and the United States, with \$324 million and \$317 million respectively. (Comment: The increased inflows are the result of a GOP crackdown on informal money changers as well as the SBP's Pakistan Remittance Initiative (PRI) which has simplified and expedited the formal money transfer system.)

13. (SBU) The conflict between the GOP, courts, and sugar mills intensified, even as demand for sugar fell during the Eid holidays. On September 24, the Lahore High Court (LHC) accepted a petition to initiate contempt of court action against parties involved in price-setting negotiations, including the Federal Minister of Industries Manzoor Wattoo, and leaders of the Sugar Millers Association. Pakistan's Supreme Court had already refused, on September 16, to stay a LHC September 3 decision instructing the Punjab government to ensure a retail price for sugar of Rs. 40 per kilo, roughly twenty percent below the previous fixed rate. Following that, on September 18, it agreed to review a petition from the federal and provincial governments to overturn the price decree.

At the time of this writing, the Supreme Court is hearing a preliminary report from the Competition Commission of Pakistan (CCP), accusing sugar millers of illegal cartelization. (Comment: Both the federal and provincial courts appear to be styling themselves the champions of the people in a struggle against the business and political elite. LHC's agreement to hear the petition requesting the sugar miller's be held in contempt is a formality that also gives the court an opportunity to demand that officials, including federal bureaucrats, explain the sugar pricing mechanism

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in the country. Coming on the heels of the federal and provincial governments' joint appeal of the LHC ruling, the provincial court's actions feed the "masses as victims" narrative. Thanks to escalating tensions, Pakistani sugar millers had to opt out of a visit to the United States sponsored by the U.S. Trade Development Agency to learn how U.S. mill operations generate excess electricity for the national power grid. The fight is likely to result in more mudslinging before the matter is resolved, and is only the latest in a long string of disastrous interventions in markets.)

14. (SBU) President Asif Ali Zardari announces the "Waseela-e-Haq" program under auspices of the Benazir Income Support Program (BISP).

BISP will now target socio-economic empowerment for women by providing them greater opportunities for self-employment. It will do this by selecting 731 families at random, through a monthly drawing, giving them each Rs 300,000 to create a business. (Comment: Random selection could rule out potential corruption or patronage in granting the seed money, but it also limits the GOP's ability to maximize fund benefits: there is no requirement that "winners" have a sound business plan or even an idea on the drawing board. The GOP does not intend to provide technical assistance, nor will it be tracking the new businesses' success or failure.)

15. (SBU) Foreign Direct Investment (FDI) declined 57.4 percent in July-August 2009. The SBP reports that FDI was down to \$351 million in the period July-August, a 57 percent decline from the \$825 million recorded for the same period last year. This is in spite of portfolio investment that posted a 134 percent increase brought on by investors' attraction to high profit margins, some undervalued equities, and improvements on the national front, namely increased foreign exchange reserves and lower inflation. (Comment: Even with relatively high profit margins and some improvement in macroeconomic fundamentals attracting transactions at the exchange, foreign direct investors are more reluctant to risk investment because of the high cost of doing business in Pakistan mostly due to inadequate infrastructure and the security problem.)

16. (SBU) The GOP released Rs. 85 billion to erase debt in the power sector on September 19. The government raised the funds through the sale of Term Finance Certificates (TFCs). (Comment: Though the issuance of the TFCs and removal of arrears was a necessary first step in resolving the debt crisis in the energy sector, the crisis will not be resolved until tariff rates cover the cost of energy production and distribution. The GOP agreed with the IFIs to raise

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tariffs in three tranches, beginning with 6 percent on October 1.)  
¶7. (SBU) Ministry of Commerce (MoC) making plans for Reconstruction Opportunity Zones (ROZs) in FATA, AJK, NWFP and Balochistan. According to a working paper presented to the Planning Commission, the MoC is moving closer to establishing a two-year Program Management Unit (PMU) responsible for developing incentive packages for investors, systematize enforcement procedures, guard against unlawful transshipment of articles from ROZs, and coordinate with donor agencies to identify projects within the ROZs. Solicitation for a director and other PMU staff closes September 30. (Comment: The MoC expects to establish the PMU in October with Rs. 80.6 million in funding.)

¶8. (SBU) Pakistan's cement industry is reacting to an 80 percent decline in exports to India in recent months. The News reported that the cement industry has been seeking alternative markets due to the much lower sales to India. One Pakistani manufacturer has sent consignments to Sri Lanka, South Africa, Namibia, Oman and Mauritius, and others have begun looking to European markets. (Comment: Cement exports to India have slowed due to increased Indian capacity and competition. Shipping costs of heavy bulk goods to distant foreign markets are often cost prohibitive. Profit margins in these new markets would be significantly lower than sales to India.)

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BANKING AND FINANCE  
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¶9. (SBU) On September 11, Dawn reported that assets of Islamic banking institutions in Pakistan reached Rs. 313 billion in June 2009, up from Rs. 278 billion the previous year. The investment portfolio of Islamic banks has also increased to Rs. 195 billion, up from Rs. 185 billion in March 2009. The SBP hopes that by 2012, Islamic financial institutions will account for 12 percent of all banking in Pakistan. (Comment: Islamic banking institutions have realized growth rates higher than conventional finance institutions in the Middle East and Asia the past few years, benefitting from new regulations and standards, and a higher awareness due to stepped-up marketing by the banks.)

¶10. (SBU) On September 12, Dawn reported that the Securities and Exchange Commission of Pakistan (SECP) has imposed requirements for "Modarabas" (Islamic financial and investment partnerships) to guard against money laundering, terrorist financing and other illicit activities. According to these reports, Modarabas would be required

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to implement procedures to ensure due diligence screening of customers, and to adopt "know-your customer" policies to be approved by the board of directors of management companies, which are also to be created. (Comment: Under Modarabas partnerships, one party provides finance to another party for the purpose of carrying on a business. The party who provides the finance is the 'Rabb-ul-Mal', and the funded working partner is the 'Modarib'. This is another welcome step forward in GOP efforts to increase accountability in the banking sector.)

¶11. (SBU) On September 17, the News and other papers reported that the SBP has re-engineered its treasury operations on foreign exchange interbank deals, trade confirmations, and settlements to bring them more in line with international best practices. All banks have been advised of the proposed changes and have been urged to ensure compliance. (Comment: For more information on the specific changes please refer to <http://www.sbp.org.pk/tod/2009/C01.pdf>)

¶12. (SBU) On September 25, Business Day, the News and other papers reported that Pakistan's total liquid foreign reserves have increased to an all-time high of \$14.47 billion. On Sept 19, foreign reserves held by the SBP stood at \$10.94 billion and net foreign reserves held by other banks in the country stood at \$3.53 billion. (Comment: SBP reserves stood at only \$4.9 billion a year ago. Relative fiscal prudence, IMF inflows, and higher official remittances have all contributed to the higher reserves.)

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## STOCK MARKET

113. (SBU) September 25 saw record turnover at the Karachi Stock Exchange, for the last 1.5 year trading period. Habib Bank noted that trading was boosted by the Friends of Democratic Pakistan meeting in New York and the passage of the Kerry-Lugar Bill. Over the two week period, the KSE index rose from 9,058 to 9,664, market capitalization increased from \$31.8 billion to \$33.8 billion, and net foreign portfolio investment inflows continued, totaling approximately \$45 million.

114. (SBU) On September 16, the media reported that the Karachi Stock Exchange (KSE) adopted the Industry Classification Benchmark (ICB) system, used for sector and industry classification and analysis.

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The system was first launched by London's FTSE and the Dow Jones Indexes and is in use worldwide. (Comment: KSE has joined other exchanges and global financial institutions which have integrated ICB into their research, trading and investment workflows. The adoption of ICB will also assist an overall strategy to introduce derivative and structured products at the exchange.)

115. (SBU) The Lahore Stock Exchange (LSE) Index continued to climb in recent weeks, surpassing 3,000 and doubling the market's position since the beginning of the year. Market capitalization kept pace with share prices and volume was heavy.

## PROVINCIAL FINANCES

116. (SBU) The Punjab government converted an \$850 million revolving line of credit into a four-year term loan. The debt had piled up largely because of deficit spending on subsidies for wheat, roti (local bread), and sugar. The conversion to the term loan, arranged with the State Bank of Pakistan (SBP), is largely designed to reduce interest charges. Punjab will still have a line of credit, but a senior Punjab bureaucrat stated that the new line is not nearly as large as the old one, a resizing that reflects Punjab's inability to curb spending. (Comment: Punjab's profligate ways will be subject to increasing constraints, as future deficit spending on subsidies and development projects in Punjab will have to be financed in advance through loans or bonds either through commercial banks or the SBP, neither of which will be cheap or easy.)

## ENERGY, POWER AND WATER

117. (SBU) Water levels in the Tarbela and Mangla dams dropped precipitously in September, according to Water and Power Development Authority (WAPDA) data. Tarbela has been falling two feet per day, and Mangla one foot per day. Large water releases that were made for the current cotton and rice crops vastly exceeded inflows, which were lower than normal for this time of year. (Comment: Current demand has trumped any concerns about the future. If river flows remain low, Pakistan could face a severe water shortage this November when the next wheat crop is sown, precipitating yet another wheat crisis.)

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118. (SBU) On September 20, the News and other papers reported that owners of compressed natural gas (CNG) stations are worried about GOP plans to switch off natural gas supplies for CNG use this coming winter. Pakistan, in the face of a severe energy crisis, has been cutting back on gas supplies to CNG filling stations, which are not considered a priority industry. Around 2.4 million vehicles utilize CNG however. (Comment: The GOP's plans to suspend supply to a sector that consumes only six percent of the nation's total gas supply indicates desperate measures to try and meet the growing needs of the power sector. The CNG industry will be severely

impacted; not only will 2.4 million car owners be effected, 2500 CNG station owners will be hard pressed to cover over Rs. 90 million invested in retrofitting their facilities for CNG.)

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TRADE  
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¶19. (SBU) On September 12, Business Recorder reported the country's largest custom clearing system, Pakistan Customs Computerized System (PaCCS), is in danger of being shut down unless a final agreement is reached with its service provider, Agility, a leading Kuwait based logistics operator. Agility has been providing service to the PaCCS without pay since April 2009, due to expiration of its service agreement with the Federal Board of Revenue. (Comment: PaCCS enables importers and exporters to file customs declarations online, pay duties at their nearest local national bank, and clear cargo without visiting a customs office. It was put into place 3 years ago, and has been well received by the terminals (the Ports of Karachi and Qasim) who have enjoyed increased efficiencies and better transparency. Despite its success, the GOP has refused to renew the PaCCS operating contract. There are rumors that customs officials at FBR are trying to find an alternative to PaCCS in order to game the system and collect kickbacks. The terminal companies say that PaCCS has effectively limited corruption.)

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AGRICULTURE  
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¶20. (SBU) On September 25, Business Recorder reported on the potential for significant cotton shortages throughout the country due to an outbreak of the cotton leaf curl virus (CLCV). This

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deadly pest, caused from the use of uncertified and illegal cottonseeds, has badly hit cotton crops across the country. (Comment: The Sindh Abadgar Board (SAB) and Sindh Chamber of Agriculture confirmed the report and said there are estimated CLVC related damages of 5 to 10 percent in upper Sindh, and warned that up to 70 percent of crops may have been affected in Punjab.)

¶21. (SBU) The GOP is predicting a one million-ton sugar shortfall in the next year due to a low sugarcane harvest. The Business Recorder reported that the poor harvest will be a result of this year's 'worst ever' treatment of sugar growers by mill owners who have further depressed prices paid for sugar stocks. In view of the situation, the GOP plans to bridge the gap with 0.7 million tons of raw sugar imports in the upcoming crushing season, and the Economic Co-ordination Committee (ECC) has allowed 0.3 million tons of raw sugar imports by the private sector this year. (Comment: There is some evidence that cane growers were actually paid a decent price and were paid faster than most previous years (because the government forced millers to do so). Agricultural acres in cane production have indeed declined, but mostly because of the high support price for wheat. Note further that cane yields, like most other crops in Pakistan, are lower than they should be.)

PATTERSON